

INTRODUCTION

A body of statutes, regulations and administrative rulings, both Federal and State, is an element of the regulatory framework within which banks operate. Their underlying rationale is the protection of the general public (depositors, consumers, investors, creditors, etc.) by establishing boundaries and standards within which banking activities may be conducted. The FDIC assigns a high priority to the detection and prompt correction of violations in its examination and supervisory programs. It is therefore essential for examiners to have a thorough knowledge of Federal and State laws and regulations pertinent to the bank being examined.

I. BASIC CAUSES AND SIGNIFICANCE OF VIOLATIONS

Causes

Although the possible causes of violations of laws and regulations may be many and diverse, infractions most often result from management's unfamiliarity with governing statutes or regulations, negligence, misinterpretation of statutory or regulatory requirements or prohibitions, and/or willful noncompliance.

To address the first two general causes of violations, the bank's board of directors and/or senior management should develop:

1. Policies and procedures to ensure that officers and employees are sufficiently familiar with laws and regulations,
2. Monitoring systems to assure compliance in daily operations, and
3. Practices or procedures to detect noncompliance and report it to the board of directors and/or management so corrective measures may be promptly initiated.

Honest differences of opinion may sometimes arise with regard to interpretation of laws or regulations. It may be necessary in such situations, especially where examiners are in doubt as to the applicability or meaning of a State statute or regulation, to consult with the Regional Office so the matter can be resolved.

Willful noncompliance is the most serious of all the possible causes of violations and needs to be thoroughly investigated by examiners. Depending on the gravity of the offense and other factors, willful noncompliance may result in recommending assessment of civil money penalties and/or consideration of action under Section 8 of the Federal Deposit Insurance Act.

Significance

The broad objective of protecting the interests of the general public is reason enough for banking activities to be conducted in accordance with laws and regulations. Bank directors and officers should be aware, however, there can be a more direct, immediate and personal reason why such activities should be legally conforming. A number of Federal statutes and regulations (and those of some states) include provisions for assessing civil money penalties against banks and/or individuals for certain infractions. In addition, laws of most states provide that directors may be held personally liable for losses sustained by a bank on illegal loans or the acquisition and holding of other nonconforming assets. Finally, infractions of laws and regulations may prompt litigation and requests for money damages by parties adversely affected by these illegal act(s). Successful legal actions by these parties could irreparably harm the institution if settlements were large.

II. SCHEDULING VIOLATIONS

The Violations of Laws and Regulations schedule is designed to cover violations of laws and regulations discovered during safety and soundness examinations, whether or not a dollar amount is involved. Inclusion of all violations of laws and regulations in one schedule of the examination report is desirable for the following reasons: it eliminates the necessity of including numerous separate schedules in the report, each devoted to a particular type of violation; it permits a more satisfactory review of the extent and nature of the problems in a given bank; and it results in a more forceful presentation to the officials of the examined bank.

In the Violations of Laws and Regulations schedule, examiners report and document situations which appear to be contraventions of law or regulation.

However, since examiners are not final adjudicators, findings must be qualified by using the expression "apparent violation" to describe the situation, regardless of the certainty upon which the judgment is founded. Care should be exercised in scheduling apparent violations, for the erroneous designation of a violation tends to discredit the report of examination. Refer to the Report of Examination Instructions for additional guidance in scheduling apparent violations.

In order to reflect director responsibility and possible liability, it is essential that report comments include the names of directors who approved apparently illegal transactions and the date such approval was accorded. Names of dissenting directors should also be reflected. This procedure should be followed even if approval consisted merely of ratification of a group of loans, possibly identified only by numbers. When citing apparent infractions, the examiner should also state the apparent cause(s) of the violation and include management's comments or commitments as to corrective action planned. If the violation is corrected during the examination, this should be stated. When scheduling apparent violations of the FDIC's Rules and Regulations, it is generally necessary to cite the specific section or subsection of the regulation deemed to have been violated, e.g., Section 328.2 or Section 329.1(e) and the specific reasons therefor. On the other hand, any reference to a general regulation dealing with a particular subject is cited by part number, e.g., Part 329.

Comments should be as concise as the circumstances permit. Detailed descriptions and extensive remarks on violations which involve certain assets, such as adversely classified loans, may be unnecessary if appropriate reference can be made to other schedules within the examination report.

III. TYPES OF VIOLATIONS

The following discussion covers some of the more common types of violations encountered in safety and soundness examinations. Some of these violations relate to nonconforming assets (assets acquired or held by the bank in violation of law), while others are

not associated with particular assets.

Nonconforming Assets Held

Extensions of Credit Which Exceed Bank's Legal Loan Limit - A borrower's line of credit may consist of several notes of different dates. While the total of such notes may constitute an excess line, the courts generally have held that only the note(s) which created the excess line constitutes an illegal extension. Therefore, only the advance(s) that caused the excess over the bank's legal limit will be extended. However, if this method differs from State law or practice, the latter should prevail.

To illustrate, assume the statutory lending limit for a bank is \$200,000 to any one borrower. The borrower's line of credit consists of three original notes of various dates, each in the amount of \$100,000. Generally, only the last note advanced has been held by the courts to be illegal. Until paid in full by the borrower, it may be a legal liability of the approving directors. The courts have also held that if several notes constitute a single transaction, the entire transaction should be treated as a unit and the entire loan considered an illegal extension for which the approving director may be held liable.

Citation of excess loan violations is to be restricted to those lines currently in excess of the bank's legal loan limit. While the directors' liability is not eliminated by reduction of an illegally excessive loan, effectiveness of the schedule is impaired by continued listing of such lines.

Nonconforming Extensions of Credit to Insiders - It is especially important that illegal credit extensions to directors, officers, employees, principal shareholders, and their interests be properly reported and corrected within the shortest possible time. Directors and officers of banks are representatives of not only the stockholders, but also depositors. Their responsibilities approach those of a trusteeship, since banks to a large extent operate with funds supplied by other than owners. Therefore, it follows that directors who allow nonconforming extensions of credit to themselves, to other members of the bank's official family, or to their business interests, are violating that trust.

Nonconforming extensions of credit to insiders

and their interests may involve contraventions of not only State law but also Federal Reserve Regulation O and Section 337.3 of the FDIC Rules and Regulations. These regulations set limitations as to maximum amounts of insider indebtedness, establish certain recordkeeping requirements, and prohibit preferential terms or conditions on insider loans. Violations of Regulation O may be subject to civil money penalties. A more comprehensive discussion of these regulations is contained in the Management Supervision, Administration and Control Section of this Manual.

Nonconforming Extensions of Credit to Affiliates - All nonconforming advances to an affiliate or illegal investments in securities of an affiliate, including illegal extensions of credit to others collateralized by securities of an affiliate, are to be included as violations.

Transactions with affiliated organizations can, under certain conditions and circumstances, prove detrimental to the best interests of banks. Provisions of Section 23A of the Federal Reserve Act place restrictions on loans and dealings between member banks and their affiliates. These provisions are made applicable to nonmember banks by Section 18(j) of the Federal Deposit Insurance Act. Affiliates and the Federal statutes applicable to them are more fully discussed in the Related Organizations Section of this Manual.

Loans on Which Real Estate Security Has Been Taken or Is Held in Violation of Law - In many states, laws restrict the type of real estate which can be taken as loan collateral by a bank. Limits may also be placed on the amount of a loan which can be advanced in relation to appraised value; title opinions, appraisals and reappraisals may be required; and limits on the total amount of real estate loans which can be carried by a bank at any particular time may be established. Whenever violations of these provisions are discovered, the current book value of the illegal real estate loan(s) should be scheduled. In those cases where aggregate real estate loans outstanding constitute an infraction, only the amount in excess of prescribed limitations should be extended.

Loans on Which Securities Have Been Taken or Are Held in Violation of Law - Current balances of loans on which securities have been taken in violation of law should also be included.

Infractions of this type might include extensions of credit secured by own bank stock or apparent violations of Federal Reserve Regulation U.

United States Treasury Department regulations generally prohibit the pledging of certain savings bonds as collateral to a debt. In those cases where banks take such ineligible bonds as purported collateral, examiners should not recognize the loan as secured. However, the loan itself is not to be regarded as a violation and should not be included in this schedule, unless it is otherwise nonconforming; for example, it lacks a supporting financial statement required by State law for unsecured loans.

Securities Unlawfully Acquired or Held - Many states have restrictions on the type and/or amounts of securities in which a bank may invest. For example, a bank may be prohibited from acquiring common stock or certain other forms of equity investments. Exceptions are sometimes allowed for investments in subsidiaries holding title to bank premises, stock in bank service corporations, or securities taken in consideration for debts previously contracted (DPC). If a security is deemed to have been unlawfully acquired or held, the current book value amount should be extended as a violation.

Other Real Estate Acquired or Held in Violation of Law - Unless State law specifically requires a bank to divest itself of ownership within a specified period of time or rulings of the State authority provide otherwise, real estate acquired DPC and held by the bank for a longer period than permitted by statute or regulation normally will not be included in this schedule, if carried at a nominal value for identification purposes. Charged-off real estate which the bank purchased illegally, as distinguished from charged-off real estate acquired DPC, should be scheduled as an apparent violation.

Charged-Off Nonconforming Assets - An illegally held or acquired asset is still illegal at its original amount, whether or not it has been partially or completely charged-off the bank's books. If an excessive loan is made, the mere fact the bank charges off a portion of the debt does not extinguish the borrower's liability or bring the loan into conforming status. Were this interpretation not placed on the law, bank management, desiring to accommodate a borrower beyond the legal limit, could make

excessive new loans and simply charge them down immediately to the legal limit, or eliminate them from the books completely. The same general rule holds true with regard to most other types of nonconforming assets.

All Other Violations

These violations of applicable laws and regulations are not associated or identified with the acquisition or holding of a nonconforming asset. They include most apparent violations of the Federal Deposit Insurance Act, the FDIC Rules and Regulations, the Bank Holding Company Act, and other similar Federal or State laws and regulations.

However, certain of these apparent violations are not scheduled in the safety and soundness report of examination. For example, apparent infractions of the Federal criminal code are reported separately, and infractions of the Truth in Lending Act or Equal Credit Opportunity Act are excluded since they are covered during separate compliance examinations.

ensure compliance, prompt detection of instances of noncompliance, immediate institution of measures to effect correction, and adequate training and retraining of officers and employees to prevent future infractions. To the extent deficiencies in these functions result in violations, it is an adverse reflection on management's capabilities and should be recognized accordingly in the overall assessment of management. As stated previously in this section, the causes of apparent infractions must play a significant role in this assessment. Willful noncompliance, for example, obviously reflects much more unfavorably on management than does a violation which results from unfamiliarity with a minor provision of a technically complex statute. Nonetheless, it is important that correction of all apparent infractions be instituted promptly, regardless of their perceived importance.

IV. CONTRAVENTIONS OF FDIC STATEMENTS OF POLICY

Contraventions of FDIC policy statements should be included in the Violations of Laws and Regulations schedule in the examination report when the examiner believes there is a legitimate safety and soundness concern. All contraventions of FDIC Statements of Policy should be segregated under an appropriate subheading and listed after the apparent violations cited. Refer to the Report of Examination Instructions for additional guidance.

V. VIOLATIONS AND THE EVALUATION OF BANK MANAGEMENT

A bank's adherence to applicable laws and regulations should be considered when assessing and ranking the management component of the CAMEL rating system. Compliance with statutory and regulatory provisions is more likely achieved when the importance of legally conforming behavior is recognized by the board of directors and senior management, and when this commitment is backed by appropriate policies and procedures. These policies and procedures must